


Shopping Centres in ESG Wonderland

In recent times, the shopping sector¹ has risked becoming like the Mock Turtle, reminiscing about the good old days. Is it time for the sector to take a direction and reinvent itself in an ESG Wonderland?

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Now, here, you see, it takes all the running you can do, to keep in the same place. If you want to get somewhere else, you must run at least twice as fast as that!

Lewis Carroll, from Alice's Adventures in Wonderland

¹The focus of this article rests on shopping centres, factory outlet centres and retail centres (hereinafter collectively referred to as "Shopping Centres").

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The good old days



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If you look at it from a real estate perspective, the business model of a Shopping Centre is simple. An investor buys a plot of land, obtains planning permission, constructs a building with standardised retail units, and rents those out for as long as possible. Given the large number of rental units, the risk of catastrophic default is manageable. The landlord meanwhile participates directly in the tenant's turnover and can – in theory – fall back softly onto a guaranteed base rent if turnover diminishes. For decades then, it is no surprise this business model proved so attractive that banks provided a lot of debt capital and high leverage ensured fantastic returns on equity.

Fast forward to today's world however, and the picture is more curious. In reality, the business model is based on the promise of buoyant turnover rents and these are under pressure like never before. Shopping Centres were already dealing with the challenges to turnover calculations from burgeoning online retail, and then the pandemic balkanised visitor flows overnight. More tenants faced insolvency, defaults increased and energy costs have also drastically increased. As tenant turnover collapses, the Shopping Centre sector of old rapidly loses its appeal, and the onus is firmly on key players to pivot into new and sustainable models. And just like Alice, the curious girl in a blue dress who took a leap of faith following the talking White Rabbit to an enchanted world, Shopping Centres are grappling with the laws, logic and opportunities within an ESG wonderland.

At first glance, the laws and logic of the ESG wonderland may seem incoherent. Amid reports that the real estate sector is responsible for a large share of carbon emissions, the economic pressure imposed by ESG requirements in the landlord and tenant world is enormous. Tenants want to please their customers by grandstanding ESG achievements and commitments, but of course they need the cooperation of their landlords, who are also accountable to their own banks and shareholders. Until recently, the issue of ESG could be more or less dismissed by Shopping Centre landlords. Cursory attempts to paint any leases green were not much challenged, and the outcome of any ESG initiatives on Shopping Centre estates were not subject to rigorous analysis. It was as if they had wandered around the Queen's garden until they met the Cheshire Cat. "Would you tell me, please, which way I ought to go from here?" "That depends a good deal on where you want to get to," said the Cat. "I don't much care where," said Alice.

These days however, ESG is a hard currency. As far as valuations go, there is much talk of ESG manifesting in a green premium for compliant properties, rather than a brown discount for the stock without ESG credentials. And those real estate operators who are not on top of ESG rules or directives face a harsh economic reality – prices go up: banks charge higher interest rates if a property does not meet requirements; investors apply pressure; tenants turn away or demand up-to-date energy efficient fittings without wanting to pay for the costs themselves. The landlords failing to rise to the ESG challenge fear judgement by the Queen of Hearts: "Off with his head!"

The aim of this article is not to describe in detail all the rules of the ESG wonderland. Rather the aim is to outline its logic as it applies to the Shopping Centre sector to consider the ESG issues that arise for investors, operators and retail brands (Part 2). By focusing on the typical lease agreement as the core document generating cash flow for every Shopping Centre, Part 3 offers some practical guidance for dealing with ESG issues. This article is expressly not an exhaustive legal elaboration: the starting point is EU requirements but aspects of domestic law are deliberately omitted. That said, while the glasses of the author are coloured by years of experience dealing with German Shopping Centre lease agreements, many similar issues arrive throughout the world.

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The ESG wonderland

For over two decades, the real estate industry has relied on its own criteria to assess a building's environmental factors and energy use (whether in construction or in operation), often applying standards on a voluntary basis. The landscape has changed dramatically over the past few years however as more and more official regulations evolve across the globe. Europe is currently considered a front runner and the world's superregulator in many fields after having announced the European Green Deal in 2019, but other regions are quickly catching up.² The EU's ESG approach is globally competing with other concepts.³ In some countries, there is even an anti-ESG backlash.⁴ Nonetheless, the EU approach offers a good example to illustrate how quickly and profoundly the application of mandatory regulations can transform an entire industry.⁵

1. The EU approach

"In many ways, the ESG regulations go back to an ingenious idea of the European Union. Market participants are not exposed to penalties or even to any direct requirements to adhere to sustainability strategies. They are only asked to disclose information about their sustainable investments and to report properly. And with the market's rapidly growing appetite for sustainable investments, every investor that does not want to fall behind has to operate in the glare of these disclosure rules and and strive for transparency.

It all started⁶ in 2019, with the Sustainable Finance Disclosure Regulation (SFDR). This requires transparency from the financial services sector, at both entity and product level.⁷ Recently, the same concept has been expanded to large companies with the Corporate Sustainability Reporting Directive (CSRD). This introduced more detailed reporting requirements,⁸ requiring large companies to report on sustainability issues such as environmental rights, social rights, human rights and governance factors. The CSRD also introduces a certification requirement for sustainability reporting, as well as improved accessibility of information via publication in a dedicated section of company management reports.⁹ On an operational level, both the SFDR and the CSRD are backed up by regulations providing for definitions and technical screening criteria. These determine the conditions under which an economic activity can qualify as being sustainable. The intention of the EU Taxonomy Regulation is to amend the SFDR and create a (still incomplete) classification system, thus increasing transparency and preventing greenwashing.¹⁰ Meanwhile, the CSRD will soon be complemented by the European Sustainable Reporting Standards (ESRS), which will further specify reporting requirements under the CSRD.¹¹

Concepts of ESG reporting have been readily picked up by market leaders. Investors now expect companies to produce ESG strategies and push for transparency in their own operations. The Norwegian Government Pension Fund Global gets directly to the point: "Companies' activities have a great impact on surrounding communities and the environment, and society has ever greater expectations for how companies should behave. Over time, this may

² Urban Land Institute (ULI) together with PRI and INREV: Mapping ESG, A Landscape Review of Certifications, Reporting Frameworks and Practices, 2023, page 11, Figure 1 "ESG in an international context". PRI stands for Principles for Responsible Investment and INREV means the European Association for Investors in Non-Listed Real Estate Vehicles.

³ The Schumpeter columnist of The Economist, Henry Tricks, points out: "The shifting goalposts make it harder for companies to gauge what their reporting requirements will be." Quote from "Europe and America disagree over how to handle ESG", The World Ahead, 18 November 2022.

⁴ In 2021, Texas enacted a law that stipulates how banks with ESG policies restricting credit to oil and gas companies or to fire-arms firms can no longer contract with local governments. On 7 July 2022 Daniel G. Garrett from the University of Pennsylvania, Wharton, and Ivan T. Ivanov from the Federal Reserve Bank of Chicago, posted a paper on the "Financial Costs of Anti-ESG Policies" on papers.ssrn.com. They come to the conclusion that this law caused five of the largest banks to exit municipal underwriting in the state. As a direct result, credit access decreased and borrowing costs rose.

⁵ The cut-off date for this article was 31 May 2023.

⁶ Early birds as regards corporate sustainability reporting were the Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU.

⁷ Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019.

⁸ Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022.

⁹ ULI, Mapping ESG, page 110.

¹⁰ Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020.

¹¹ The European Commission is expected to adopt these as delegated acts in June 2023.

affect their profitability and the fund's return. As a long-term investor in around 9,000 companies in 70 countries, we have an interest in investors' demands for profitability being aligned with society's broader expectations of companies. We consider environmental and social issues, and publish clear expectations of the companies we invest in."¹² If companies such as banks or retail brands want to continue to exist in the market, they have to accept the information and disclosure obligations and pass them on to their clients.

A Shopping Centre, which heavily depends on bank finance, will consequently have to ensure that technical and organisational measures are taken to meet their banks' and tenants' requirements. Information and disclosure obligations have to be passed on to tenants, with appropriate levels of accountability. Even if a Shopping Centre does not depend on bank finance, it must cope with the pressure applied by large international brands, who have to please their own investors.

There are many voices concerned that implementing ESG measures and reporting against targets is a drain on time and money. But while it may be tempting to put on a green cloak,¹³ this is not a sensible or sustainable option. If (when) detected, green washing severely damages a landlord's reputation, and the corporate directors might even be exposed to criminal prosecution.¹⁴ This could result in an economic disaster for the Shopping Centre.

2. The magic three letters

ESG is on everyone's lips. But what is it actually about? What do the three letters E-S-G stand for?

The easiest to grasp is the "E": the environmental aspect. The EU makes assumptions for the development of the global climate in the next 10 to 30 years and its EU Taxonomy consequently covers six environmental objectives: climate change mitigation; climate change adaptation; the sustainable use and protection of water and marine resources; the transition to a circular economy; pollution prevention and control; and the protection and restoration of biodiversity and eco-systems. Until now, technical screening criteria have only been defined for climate change mitigation and adaptation in relation to new buildings. The EU Taxonomy sets targets to the entire life cycle of properties however, not only new buildings, covering the renovation and modification of existing buildings, maintenance and repair, as well as acquisition and the operational ownership of buildings. The industry faces great challenges translating these targets into universally applicable standards. The first paths are emerging, but we will have to wait longer for the main road to materialise, if it can even be agreed on.¹⁵

The "S", as in "social", refers to a company's treatment of its employees, its service providers, its customers and the suppliers behind them. It covers a vast gamut of social and community impacts. It is about equal opportunities, the protection of social minorities, the prevention of exploitation and discrimination. It means complying with the fundamental decisions of labour courts. It involves ensuring adequate remuneration and fair conditions at the workplace, as well as tax honesty.¹⁶

The "G" stands for governance, and refers to the organisational structure of a company, i.e. all the rules according to which a company is managed or operated, and all processes of management and supervision. This includes topics as diverse as corruption, regulatory compliance, ESG risk management, whistleblowing, conflicts of interest and even the remuneration of a company's executive board and supervisory board.

3. Further development and relevance for Shopping Centres

So far, the EU sustainability regulations do not affect all market participants. The taxonomy rules are still perforated, although the gaps are likely to be closed gradually. Until reporting requirements are standardised, risk analysis and

¹² www.nbim.no/en/the-fund/about-the-fund.

¹³ Henry Tricks believes that the "ESG approach to investment is broken and that it needs to be streamlined and stripped of sanctimoniousness." The Economist, A broken system needs urgent repairs, Special Report, 21 July 2022.

¹⁴ According to the German weekly magazine DER SPIEGEL "Desirée Fixler had only been head of sustainability at fund company DWS, a subsidiary of Deutsche Bank, for a few months when she was fired in spring 2021. The American had accused management internally of having portrayed DWS as being for "greener" than it actually was. The whistleblower lost the subsequent trial before the Frankfurt Labour Court. Authorities in Germany and the United States are nevertheless following up on Fixler's 'green-washing' allegations. In the meantime, the former CEO has had to leave DWS, and Supervisory Board Chair is departing at the end of October 2023. Interview conducted by Tim Bartz on 12 May 2023 (www.spiegel.de/international/business/).

¹⁵ The ULI report "Mapping ESG" considers 14 frameworks standards, out of which ten have real estate-specific metrics. It predicts on page 58: "Although different standards will continue to exist in the future due to their different purpose and stakeholder needs; it is anticipated that there will be further consolidation and alignment of standards which have an overlapping purpose."

¹⁶ Schmidt, ESG und Taxonomie in der Gewerberaummierte, ESG 2022, page 132.

implementation plans are likely to remain at the discretion of individual stakeholders. Still, while the EU is aware that there is no “one size fits all” solution, new rules for the collection and documentation of data are likely to develop rapidly. Meanwhile, the ESG ratings industry is still highly fragmented. Dozens of rating agencies and data providers exist, many having diversified into this new field from different areas of historical expertise.¹⁷ Ultimately, we expect to end up with a few global rating systems, dominated by the three leading rating agencies in the world.¹⁸

Sustainability regulations do not currently impose any direct requirements on lease agreements, but market leaders have their sights firmly on these documents for their ability to help corporates deliver on their own ESG goals. Shopping Centres are no exception. Under pressure from their tenants, banks and investors, many market leading Shopping Centres have started to analyse their existing lease agreements for opportunities in terms of their compliance with their own ESG requirements. They conduct risk analyses, decide on packages of measures and look to incorporate ESG clauses in new lease agreements and streamline construction and service contracts. They introduce data collection systems to monitor compliance with ESG regulations. Struggling with the ESG jungle however, they are all longing for a clear pathway through this wonderland.

The Urban Land Institute has helpfully set out a series of self-assessment questions for real estate managers and other real estate organisations looking to understand ESG application and define their ESG ambitions:¹⁹

- “In which jurisdiction do you operate? Where are your assets and where are your (target) investors?”
- Which regulation applies in those countries/regions? How is this relevant for your fund/company?”
- At which levels and in which areas do national and international regulations have an impact on your real estate organisation?”
- What stakeholders (type, geographic domicile, etc) do you have and what are their ESG-specific requirements?”
- What is your level of ambition? Do you want to implement only the minimum market requirements? [...] Do you want to set priorities that go beyond the minimum requirements? [...] Do you want to become a strategic leader in ESG in the real estate sector? [...]
- What is the purpose of your ESG reporting? [...]
- Do you have a holistic ESG approach or a specific climate change/environmental focus?”
- Does your company have a predefined reporting timeframe? [...]
- Do you have specific building level targets? [...]”

So what does this mean for the drafting of lease agreements for Shopping Centres?



¹⁷ Brian Tayan (Stanford University), ESG Ratings: A Compass without Direction, posted on 24 August 2022 (www.corpgov.law.harvard.edu/2022/08/24/esg-ratings-a-compass-without-direction).

¹⁸ The consolidation process is on its way. For example, Standard & Poors bought the ESG rating provider Trucost in 2016 and Moody's acquired majority stakes in Vigeo Eiris and in Four Twenty Seven in 2019 according to Brian Tayan (see footnote above).

¹⁹ ULI, Mapping ESG, page 60.

ESG issues in the lease agreement for Shopping Centres

1. Framework

Every landlord and tenant approaching the exercise of implementing ESG issues into their lease agreements will have to start by exploring potential initial and long-term measures within the legal and economic framework.

1.1 Programme

Identifying necessary ESG measures to incorporate into lease agreements and aligning them with key stakeholders' concerns is a complex exercise. For example, when it comes to agreement on saving energy and reducing CO₂ emissions, it means, inter alia, reflecting on the following aspects in light of any potential refurbishment and the operation of the Shopping Centre:

- A plan of measures submitted by experts to improve building efficiency should be properly implemented within a timeline of, for example, five years. Ideally, the tenant should tolerate these measures and be prepared to shoulder all or part of the related costs.
- To monitor energy consumption, the tenant will need to accept smart metering points in its unit, and/or agree to make energy data collected in its unit available to the landlord, who collects and evaluates it.
- The landlord will want to reserve the right to implement further measures to save energy and reduce CO₂ emissions – if necessary without the tenant's separate consent – in order to remain flexible for achieving a defined or new certificate or benchmark.
- The tenant will need to accept reporting obligations, especially those which are in turn imposed on the landlord by its financing bank.
- The landlord will want to establish rules for the sustainable use of the Shopping Centre, and the respective unit, as well as for the reporting of grievances that could jeopardise the achievement of certification.
- A violation of these rules should be punishable by sanctions, such as contractual penalties.
- The tenant may need to appoint and train one or more contact employees for ESG issues.
- Moving forward, both parties will have to react to and adopt new developments and regulations.

1.2 Legal framework and due diligence

The implementation of all the issues detailed above in the lease agreement can only succeed within the legal framework that applies to the respective Shopping Centre. This will include:

- Domestic rules in addition to EU laws: For example, Germany charges a CO₂-tax²⁰ and the Building Energy Act²¹ contains requirements for the energy quality of buildings, the preparation and use of energy performance certificates and the use of renewable energies.
- The development plan and building permit: Any municipality in which a Shopping Centre is located will benefit directly (via trade tax) or indirectly (employees, tourism), and so is likely to support ESG measures and grant necessary permits. At least from a German perspective, one would not expect restrictions to emerge from development plans, particularly those created decades ago before environmental or social standards became an issue. On the contrary, a municipality might be supportive as an ESG compliant Shopping Centre within its boundary reflects well on the municipality's forward-thinking approach.

²⁰ Since 2021, a CO₂ tax has been levied in Germany for heating with oil or natural gas. Until then, tenants had to bear such additional costs alone. From 1 January 2023, landlords have had to pay a share of the CO₂ costs for heating with fossil fuels depending on the energy status of the respective building. www.bundesregierung.de/breg-de/suche/aufteilung-co2-kosten-2043728.

²¹ For further details regarding the Building Energy Act (*Gebäudeenergiegesetz*) please refer to: www.bmwsb.bund.de/Webs/BMWSB/DE/themen/bauen/energieeffizientes-bauen-sanieren/gebäudeenergiegesetz/gebäudeenergiegesetz-node.html.

- Data protection: Since data is the foundation of most sustainability measures, data protection plays a major role. The EU General Data Protection Regulation is very strict.²² However, a landlord might not get all the necessary data easily. For example, a system measuring real time energy data must not collect any personal data. A landlord or tenant installing smart meters will have to make sure that no data can be assigned to an individual person at the tenant. It is a particular risk considering the actual flow of data from breaker boxes/ smart meters installed in a room inhabited by only one person as their behaviour could effectively be traced via the energy values.
- General terms and conditions: In all countries of the EU, regulations protecting contractual partners from the landlord's general terms and conditions must be observed.²³ On this basis, a tenant exposed to the general terms and conditions of a lease agreement might successfully challenge a clause. At least in Germany, this could have the effect that a landlord could no longer rely on the offending clause, whilst the tenant still enjoyed its benefits. Since ESG clauses tend to be reciprocal, this might mean a landlord would be forced to strictly adhere to its own rules, whilst the tenant would be off the hook. One particular example is where clauses require both parties to use "endeavours" to implement or observe specific ESG measures.²⁴
- Civil law restrictions: There might also be civil law restrictions limiting a landlord's flexibility to impose ESG rules, like the written form requirements under German law.²⁵

It is also worth remembering that the future due diligence of a financing bank or buyer, or even the drafting of a prospectus for one's own investors, should also be taken into account. Typical points of such due diligence are:

- the sustainability reports of the landlord and any tenants;
- the standard lease agreement as the core document for ESG implementation, along with a representative selection of lease agreements with key tenants;
- the construction contract documentation;
- legal restrictions on the catalogue of measures due to public law requirements (such as redevelopment statutes or urban development contracts) or neighbouring interests (arising from existing agreements with neighbours, or occurring due to emissions during a construction phase);
- specific environmental risks (for example, the location of a Shopping Centre on a flood-plain or on a site formerly used for industrial purposes);
- the investment law requirements of a potential buyer or national restrictions of a bank (for example, a German *Pfandbriefbank*); and
- tax implications of individual measures (for example, triggering trade tax or the input tax deduction).

1.3 Commercial issues

Finally, commercial issues also have to be taken into account:

- Who is responsible for the respective measures?
- Who bears the costs for each individual measure?
- Is there a difference between measures in common areas and measures in units?
- Are individual measures to be qualified as repair or renewal?
- If so, does a repair or renewal fall within the sphere of the landlord or the tenant?

²² The GDPR (EU) 2016/679 of the European Parliament and of the Council 27 April 2016 is a European Union regulation that harmonises the rules on the processing of personal data by most data controllers, both private and public, across the EU. This is intended to ensure the protection of personal data within the European Union on the one hand, and also to guarantee the free movement of data within the European Single Market on the other.

²³ The rules on general terms and conditions were largely incorporated into European Community law as EC Directive 93/13. This directive obliges the member states to enact certain legal standards that protect consumers from unfair general terms and condition. Therefore, one can expect that in principle all EU countries will have similar (if not identical) restrictions for entrepreneurs as users of general terms and conditions. A new EU regulation, which is to lead to a complete standardisation of the law on general terms and conditions (so-called maximum harmonisation), is currently being prepared.

²⁴ As one of the leading experts for the law on trade terms Dr. Friedrich Graf von Westphalen analysed the standard "green lease" which was published by the German Central Real Estate Association (*Zentraler Immobilienausschuss*) and came to the devastating conclusion that a landlord using the green lease for multiple tenants could not itself rely on the endeavour clauses. Graf von Westphalen, *Bemühensklauseln in "Grünen" Mietverträgen – Eine AGB-rechtliche Antwort*, NZM 2022, pages 1 to 8.

²⁵ Under German statutory law, either party may terminate a lease agreement, if it does not comply with the rather strict written form requirements. For this reason, any material change of the lease agreement – like the implementation of an ESG concept – will have to be captured by way of amendment.

- Or are potential measures regarded as structural changes, which are carried out by the landlord?
- How can costs be passed on to tenants (if at all) – as a one-off payment, via the (basic) rent or via the operating and ancillary costs?

1.4 Examples

The many challenges in drafting lease agreements are illustrated by the following examples:

- In the case of charging stations for electric vehicles and solar systems on roofs or parking spaces, the question arises: is the landlord allowed to operate them itself? In Germany, energy law and trade tax reasons speak against this, suggesting that the installation and operation of such systems would have to be outsourced to third parties.
- Tenant consent may be required to install metering devices for energy consumption (smart metering) or door air curtains in a let unit, unless these items were anticipated by the lease.
- While it may be simple to impose ESG specifications on a new tenant for its initial shop-fit, rules on general terms and conditions could mean an existing tenant cannot easily be given specifications for a re-fit or even for the delivery of goods (smart delivery). In this situation, laborious individual contractual regulations may be necessary.
- ESG social requirements can further complicate lease agreements for Shopping Centres. Can the tenant be required to avoid the use of tropical woods in shop fittings, for example, by referring to the EU Timber Trade Regulation?²⁶ Is the landlord allowed to dictate where the tenant's goods are sourced from, by invoking the Supply Chain Act?²⁷ Can the landlord even prevent the tenant from destroying goods that could not be sold in the Shopping Centre?²⁸
- And finally, there is the "G" in ESG to consider. To what extent must landlords and tenants provide each other with information about their own governance? Are they able to prescribe rules for each other? Should the landlord be concerned about whether the tenant has implemented the relevant whistle blowing laws?²⁹ Does the landlord have to set up a know-your-customer process?³⁰

²⁶ The European Union Timber Regulation (EU) No 995/2010 of the European Parliament and of the Council of 20 October 2010 is a trade mechanism put in place to prohibit the trade of illegally harvested timber and timber products. Another example less relevant for Shopping Centres: The EU Conflict Minerals Regulation (EU) 2017/821 of the European Parliament and of the Council of 17 May 2017 covers tin, tantalum, tungsten and gold because these are the four minerals that are most often linked to armed-conflicts and related human rights abuses.

²⁷ On 23 February 2022, the European Commission presented a Proposal for a Directive on Corporate Sustainability Due Diligence. The draft of the Corporate Sustainability Due Diligence Directive contains human rights due diligence, but also environmental due diligence obligations and requirements for corporate social responsibility. Anticipating this, the Supply Chain Act came into effect in Germany on 1 January 2023.

²⁸ Some fashion firms destroy unwanted items to prevent them being stolen or sold cheaply. This action still takes place largely under the radar of the public, although it seems to be one of the biggest challenges for Shopping Centres and their brands in terms of ESG compliance. One would assume that this practice will be banned altogether within the next five years. Since Burberry was in the press in 2018, brands have become much more cautious when it comes to destroying unsold goods. According to the BBC, Burberry destroyed unsold clothes, accessories and perfume worth £ 28.6 m to protect its brand in 2017, taking the total value of goods it has destroyed over the past five years from 2012 to more than £ 90 m (www.bbc.com/news/business-44885983). At the time, Burberry's defence was "that the energy generated from burning its products was captured, making it environmentally friendly" but this might not convince everyone today.

²⁹ The German whistle blowing law came into effect on 12 May 2023. As of 17 December 2023, this obligation will also apply to companies with at least 50 employees.

³⁰ From a German perspective, management companies, which control the operation of a Shopping Centre on behalf of the property company, are likely to be regarded as real estate agents. This means they will fall within the scope of the German Anti-Money Laundering Act. The obligations arising from the Shopping Centre's position as a so-called "obliged entity" include, for example, the creation of an effective risk management system, the auditing of individual contractual partners, and the documentation of the measures taken and their implementation.

Hurdles in the legal implementation

In an ideal world, landlords and tenants will have aligned interests and pursue the implementation of ESG requirements together. They will both be keen to make the necessary ESG investment to maintain or even increase turnover in the long term, and of course, in the world of Shopping Centres and turnover rents this benefits the tenant directly and the landlord indirectly. In reality however, ESG aspirations often collide because no binding benchmarks have yet emerged and because neither landlord nor tenant wants to bear the cost of initiatives (alone).

1. Alignment with the tenant's view

From the tenant's point of view, it is important that the landlord takes measures to reduce energy consumption and CO₂ emissions. A committed tenant is interested in the landlord's concrete action plan and its timetable for implementation. In individual cases, a tenant may even dictate to the landlord which measures are to be carried out in its unit. If individual measures are to be carried out by the tenant, they must be described in an annex to the lease and distinguished from the landlord's measures to avoid overlaps. Even where the landlord may be expected to bear the costs of ESG measures at first glance, a tenant may be prepared to share one-off costs in order to save running costs in the longer term and to obtain a better energy certification itself. Clear demarcations on cost bearing are important. During an ongoing operation, it is important for the tenant that the landlord keeps it comprehensively informed about consumption data and other energy-related parameters that are important for the tenant's own certification. Ideally, the parties even inform each other about their respective certification.

Most tenants will not want to, or even be able to, oppose the landlord's ESG plans. That said, those with greater market power may well impose requirements on the landlord that are not in line with the recommendations of the landlord's ESG advisors. In the event of conflict, the only resolution will be through individual agreement. In a Shopping Centre, the landlord will only be able to tolerate a few deviations from its overall concept. Any massive changes could jeopardise its desired certification of the whole. If at all, the landlord will more readily agree to measures that go beyond the condition it is striving for in respect of any individual unit.

2. Legal challenges

Having accepted ESG measures specified by the landlord for its shop-fit or re-fit or having agreed on an individual catalogue of measures, the tenant will want to know how these measures will be tracked. This raises several legal questions:

- Is the defined energy standard a warranted characteristic of the Shopping Centre or the unit?
- If so, can a downgrading in terms of the certification entitle the tenant to reduce the rent or even terminate the lease?
- Is there an ongoing obligation on the part of the landlord continually to adapt the Shopping Centre and the unit to meet the respective current status of ESG requirements?
- Is the tenant obliged to tolerate future measures that it does not yet know or could not have known at the time of the conclusion of the lease?
- Will refusing to tolerate future ESG measures lead to contractual penalties or even to termination of the lease agreement?

The answers to these questions can only be judged according to the law of the country in which the Shopping Centre is located. As a rule of thumb, it will probably be accepted that the landlord is bound to comply with its own defined standard, because this will form part of the guaranteed features of the Shopping Centre and because tenants are attracted to rent space in a Shopping Centre due to its high ESG standards. If the landlord fails to meet its standard,

the tenant will therefore likely be able to assert legal remedies as they are defined in the lease agreement or based on statutory law. In many continental European jurisdictions, clauses that exclude these remedies are likely to be non-binding for the tenant because of the law on general terms and conditions.

On the flip side, a tenant is more likely to have to tolerate future (increasing) ESG measures and associated restrictions where it has deliberately chosen a state-of-the-art Shopping Centre.

3. Roll-out

Of course, while a successful Shopping Centre exists as an organism with a multitude of live lease agreements, the numerous standards and initiatives of an ESG wonderland cannot easily be accommodated all at once.

In most jurisdictions, rolling out initiatives via an ESG action plan by way of a letter from the landlord is likely to be prohibited because such changes would require clear, not merely implied, consent from each tenant to be effective. Conceivably, such a letter could be countersigned by each tenant to create a lease addendum (de jure). However, due to the complexity of the issues, all the necessary changes to a lease agreement are unlikely to be reflected in a single letter.

It is advisable to implement ESG issues by way of an addendum, or to base a new lease agreement on a new ESG-compliant standard right from the outset. This can be done simultaneously for all lease agreements at a Shopping Centre or successively, whenever an addendum is due anyway. In favour of the one-off solution is the fact that an ESG roadmap may well have to meet strict timelines, which are set by a financing bank. Of course, existing tenants who refuse to conclude an addendum can hardly be forced to do so. Still, a successive roll-out across the units has the advantage that ESG issues can be accommodated more quietly whenever a lease addendum is due anyway. Lease agreements are constantly in flux, so a roll-out over a three to five year period seems realistic. Reasonable banks and shareholders are likely to take a view and go along with a long-term implementation concept.



Implementation in the standard lease agreement

For many years, Shopping Centre lease agreements resembled well-maintained gardens. Only a rosebush here would be pruned, and a weed there would be snipped. ESG is vigorously digging up this garden however. It is not enough simply to create a singular clause, planting a catalogue of measures, such as reporting and information obligations and any relating sanctions, in a new flowerbed. ESG elements will impact across other regulations in a lease agreement, such as use, the allocation of operating and ancillary costs, or undertaking cosmetic repairs as well as more fundamental repair and maintenance obligations.

Ideally, ESG regulations will be foreseen as obligations for both parties. Understandably however, landlords and tenants are still generally reluctant to accept sweeping clauses as binding because they are insecure about the consequences for their business and constraints on their flexibility. As a result, many ESG clauses still tend to swerve towards non-binding regulations or endeavour clauses³¹. The concept of “using endeavours” (or related shades such as “best endeavours”) is commonly understood in Anglo-Saxon legal systems, but less so in continental Europe.³² In combination with the strict laws on general terms and conditions therefore, Shopping Centre landlords can embark on rough new territory when trying to implement ESG elements in a standard lease agreement. And for the medium term, at least, the courts are not standing by to navigate; it is simply too early in the game for any court ruling on ESG clauses.³³

Focusing on the “E” limb is perhaps the neatest way for now to consider how ESG measures can affect a wide variety of other clauses in a lease agreement:

- Where the preamble mentions mutual sustainability goals and the will of both parties to cooperate, the landlord wants to demonstrate that this is an up-to-date lease agreement with a bespoke ESG programme.
- Regulations on a shop-fit can be crucial. If this is done by the tenant (as is so often the case), detailed technical specifications are routinely given, usually via an annex. Shopping Centres usually work with detailed specifications, so technical annexes can easily be expanded to include ESG topics. When it comes to external documentation however, it is much more effective to create a separate annex that only deals with sustainability issues. Contradictions to the conventional technical specifications can then be avoided: in case of doubt, the sustainability specifications can take precedence over the conventional regulations.
- This same system can be applied to any later alterations or modifications during the term of the lease.
- Upon termination of the lease agreement, the tenant can be required to transfer the shop-fit to its successor, to the extent possible. Whatever fixtures and fittings cannot be transferred should then be recycled.
- Any architect or contractor instructed by either the landlord or the tenant should have to observe sustainability standards. This should become a mutual obligation under the lease agreement.
- New technical devices typically require an adjustment to the maintenance and repair regulations in a lease agreement. At the very least, it should be clear that the maintenance and repair of energy-saving devices in the unit is carried out by the tenant, at the tenant’s expense.
- The landlord’s right to make structural changes may be extended with explicit reference to ESG, so that it can take future measures without tenant consent. If the tenant is also to bear the costs of such changes, a lease addendum will be necessary.
- Since observing ESG issues also affects day-to-day operations, the operating manual for each unit should be adapted. In general, the tenant should be obliged to operate its unit in accordance with defined ESG standards. In particular, this might involve relying on renewable energy, or adhering to sustainable waste disposal or cleaning requirements. A proactive landlord would of course mirror the tenant’s obligation and take on board similar obli-

³¹ Sittner, in Lindner-Figura/Oprée/Stellmann, Handbuch Geschäftsraummiere, 5th edition 2023, § 24.C.II.

³² Graf von Westphalen, NZM 2022, page 5.

³³ At least in Germany courts have not yet dealt with such clauses in more detail according to Lindner-Figura and Sittner, Die Entwicklung des Gewerberaummietrechts 2022, NZM 2023, page 1031.

gations for the operation of the common spaces.

- The landlord should reserve the right to amend or change its services to improve the Shopping Centre's ESG footprint, and tenants may well be happy to accept increases of related costs in the interests of higher ESG standards.³⁴ To avoid deterring tenants however, a landlord could offer to cap increases in operating and ancillary costs or even repay a bonus, if certain operational ESG benchmarks are met. Of course, regulations on operating and ancillary costs should be supplemented with lists of cost items for contractually agreed ESG measures, for example air curtains.
- There should be a mutual obligation to save energy and CO₂ emissions.
- The tenant should require adherence to comprehensive obligations for daily operation (for example, with regard to energy use or waste disposal) from its employees.
- A standalone ESG clause should define the criteria for the envisioned certificate. It should be stipulated that annual proof of compliance with the ESG requirements is submitted, to include detail where any breach of the ESG standards has occurred.
- Mutual rights should be granted to enable the parties to review compliance regularly, and the parties should undertake to cooperate in such reviews or investigations.
- In theory, the Shopping Centre lease agreement should contain remedies for any violation of the ESG programme. The scope of already existing penalty clauses or even special termination rights could be amended accordingly. In practice however, ESG programmes will have to be widely accepted before any tenant would accept such penalties. Any such provision in general trade terms is likely to be non-binding for the tenant in any case. For the time being, collaboration seems to be the only feasible approach in many jurisdictions.
- An ESG clause should meanwhile contain provisions for a regular meeting or exchange between the parties. After all, communication is key in a rapidly changing legal and technical environment.
- Both the landlord's and tenant's employees should be educated and trained with regard to compliance with any new ESG standards.
- Last but not least, the parties will have to cope with the ever evolving ESG world. They will have to adapt to new ESG requirements, ideally implementing a clause covering any future development.³⁵

The discussion about designing the incorporation of social requirements in lease agreements has only just begun. As the first regulations on dealing with employment aspects emerge, for example, operators and brands might consider pooling employees in the Shopping Centre while observing strict social standards. For now, parties are cautious in case adhering to any new regulation or standards backfires. If at all, however, parties might commit to an endeavour without any legal obligation sidestepping hard obligations and sanctions. In this context, a mutual confidentiality clause is essential to create an environment in which social initiatives can be discussed. When the "S" in ESG is spelt out in regulatory terms however, the parties will have to be ready to implement social obligations as hard requirements, and to do so reciprocally and collaboratively.

Of course, governance rules are also still in the shadows. For now, parties to a lease agreement for a Shopping Centre often make do with generalities such as a mutual obligation to comply with all applicable laws and regulations, especially those relating to corruption, import and export, competition, privacy, product and consumer safety, and occupational health and safety. The "G" limb of ESG gets difficult however when the tenant wants to impose a catalogue of obligations on the landlord; and it becomes unsolvable if the tenant also demands compliance with foreign laws, especially US laws. How do these regulations relate to the applicable law at the location of the Shopping Centre? Who monitors compliance? Who is liable and is there insurance cover? Since governance concerns the inner workings of a company, such regulations are rarely and only sluggishly implemented in lease agreements. However, the process towards a comprehensive implementation of governance issues will progress due to market pressure.

³⁴ Sittner, in Lindner-Figura/Oprée/Stellmann, Handbuch Geschäftsraummiere, 5th edition 2023, § 24.D.II.2.

³⁵ Schmidt, ESG und Taxonomie in der Gewerberaummiere, ESG 2022, page 136.

Result and outlook

ESG has certainly arrived in retail lease agreements, but we are still only at the edges of the rabbit hole, peering down into the certainty of change in a myriad directions. Some environmental aspects are already mandatory and sanctioned, but the “S” and the “G” do not yet play a major role.

One thing is for certain however: we are not going to find ourselves awakening on the riverbank like Alice, realising that ESG was only a dream. Against its complex backdrop, landlords will try to retain interpretative sovereignty over ESG issues with clear measures and cost allocations. They will try to set guidelines themselves and leave as little as possible to their existing or prospective tenants. Contract negotiations might lead to “do or die” situations but they will seek solidarity with anchor tenants while aiming to take smaller tenants along with them. They will roll out ESG issues gradually, rather than in one fell swoop. In this way, they will likely end up bearing the main burden, only able to impose costs on tenants to a certain extent, however in return they have an opportunity to reinvent the whole Shopping Centre sector for a new, shiny and sustainable future.

And until that comes, we have to understand that unlike Wonderland, the ESG cosmos is not a coherent fixed world, but a rapidly changing environment in which we must often run as fast as we can to keep in the same place.

